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Tax reform: good or bad for investors?

Q&A With Lamar Villere, CFA
Partner & Portfolio Manager

Q. What are your expectations for tax reforms from the current administration?

A. We don't have any specific expectations, and we think it's important not to presume anything in terms of changes to policy. At Villere & Company, we believe in staying the course and not changing with the whims of economic and political events. For that reason, we will not be making any changes to our investment style.

Q. There was post-election optimism about tax reforms and some believed small-cap companies could be key beneficiaries to those changes. That optimism has lagged as the Russell 2000 Index has underperformed the S&P 500 Index this year. What's your take on that dynamic?

A. We do believe investors are factoring in some benefit from tax reform, but exactly how much is hard to say. The Russell 2000, which is comprised of small-cap stocks like the ones we tend to favor, has significantly lagged large-caps over the last several years.

Investors could still be favoring large-caps for various reasons. It may be cheaper to invest in passive funds, or they may need income. Bonds have been paying historically low yields and investors seeking income, such as retirees, need this income from somewhere and they've been getting it from large dividend paying stocks. As a result, those types of stocks have gone up.

We believe there are more attractive valuations in some of the small- and mid-sized stocks. We view large-cap as a crowded trade and, in our experience, crowded trades typically don't end well.

Q. If reforms do occur, can you identify any sectors you believe are poised to benefit?

A. It depends how that reform lines up, particularly individual tax rates versus corporate tax rates. We believe that the proposed Trump plan is not going to be the same as what is ultimately passed. We think that any reforms made on the corporate side are likely to have somewhat of a protectionist bent, meaning they are intended to benefit US companies disproportionately from non-US companies.

Large multi-national companies, whether they be US companies or not, are going to potentially be in somewhat of a trade war. Different countries are going to have issues with however the tax plan plays out. Because of this dynamic, we believe the best place to be is in companies that have the majority of their operations and revenues coming from the US, which tend to be small-cap companies like the ones we invest in.

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Q. **Can you name a few specific examples?**

A. If the tax breaks come primarily on the consumer side for individual tax rates, then you may see a benefit to a company like Pool Corp, a company we currently invest in. Basically, if people have more disposable income, they'll be more likely to spend it, and might put it toward non-essentials like putting in a new pool or caring for an existing pool.

If the tax breaks are primarily on the corporate side, it's possible a company like Howard Hughes, a US real estate developer, would benefit from corporations being able to retain more of their earnings.

Q. **How do you think investors will react to tax reforms or tax cuts?**

A. Assuming some sort of reform happens, we think to some extent it has already been "baked in," meaning the market is already reflecting that there will be some degree of reform. Generally, I believe the reaction will be positive and would expect only a small bump in the market.

Q. **Are there any factors you believe might positively impact small-caps?**

A. The Fed unwinding quantitative easing may cause an impact since they've stated they would continue to push rates up. That could enable investors to obtain more income from bonds, which historically was the case but is less so currently. Additionally, it would allow investors seeking income to buy bonds instead of buying income stocks. While this could potentially hurt the large-cap stocks, it has the potential to benefit small-cap stocks.

Q. **Do you believe this is a good environment for "stock pickers"?**

A. Yes, as stock pickers, we believe the shift to passive investing over the last several years has led to significant opportunities and what we refer to as mispricing. It's a phenomenon where two companies that look very similar will trade very differently, not based on the quality of the company, but based on the dividends paid. The company that is growing slower might have a higher valuation than the company that is growing more quickly. It doesn't seem to make any sense, but since people have been buying things based on the income, it has created some anomalies that we don't anticipate will last.

Q. **What's your take on valuations for small-cap stocks?**

A. Generally, we think the market is fairly fully-priced, but over the last several years, small-cap stock prices have risen a lot more slowly than their large-cap brethren, which we believe leaves a lot of room for small-caps to outperform large-caps.

Q. **What's your outlook for small- and mid-caps for the remainder of this year and into next year?**

A. For the rest of this year we're generally positive, and barring any global events, expect we should see them continue to rise this year. In 2018, we believe there will be opportunity for significant outperformance by small-caps as investors begin to show preference for the companies with superior outlook.

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Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization and serves as a benchmark for small-cap stocks in the United States.

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